Committee on Resources

Subcommittee on Energy & Mineral Resources

Witness List

TESTIMONY OF

Walter Cruickshank, Associate Director

Minerals Management Service

U.S. Department of the Interior

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Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Minerals Management Service's (MMS) efforts in support of the joint Departments of Energy (DOE) and the Interior (DOI) initiative to move Federal royalty oil into the Strategic Petroleum Reserve (SPR). My testimony today will briefly: 1) describe the initiative and its status; 2) outline MMS' role; 3) address some of the operational considerations in using Federal royalty in kind (RIK) oil to add to the SPR; and 4) explain our plans for the next phase of this project.

Description and Status of the Project. The SPR RIK Initiative will be implemented in two phases.

In Phase 1, DOE and MMS are now concluding negotiations with several of the largest crude oil producing companies in the Gulf of Mexico for potential deliveries of royalty oil to DOE and the SPR starting on May 1, 1999 for a 3-month period. We realize the importance of filling the SPR as quickly as possible during this time of relatively low crude oil prices and Phase 1 has been designed to accomplish this. By targeting the largest available royalty volumes and directly negotiating with the producer, we believe we can attain efficient delivery of significant volumes to the SPR in the minimum amount of time.

To date, we have successfully negotiated arrangements with three of the largest crude oil producers in the Gulf of Mexico - Texaco, Shell, and BP-Amoco - to begin delivering approximately 38,600 barrels per day of oil to add to the Federal government emergency stockpile. Over the 3-month term of this first phase, these companies will deliver nearly 3.5 million barrels of oil to DOE at the St. James market center for further movement into the SPR facility at Bayou Choctaw, Louisiana. Continuing negotiations may provide additional royalty oil volumes to the SPR in Phase 1.

Phase 1 agreements provide for delivery at the St. James market center of volumes of oil that are less than the government's royalty volume entitlement at the lease. This reduction in volume reflects both transportation and the quality and location differentials between the generally higher quality of crude oil delivered to DOE at the market center and the royalty oil at the lease. Negotiations focused on the amount and value of these factors.

Under Phase 2, the SPR RIK Initiative will expand to potentially take the remaining volumes identified for the program and increase the fill rate for the SPR. DOE and MMS will conduct a competitive auction in Phase 2 in which royalty oil at the lease will be offered in exchange for delivery of crude oil meeting SPR specifications to locations at or near at least two SPR facilities. Royalty volumes on the order of 70,000 to 100,000 barrels per day are anticipated to be available for bidding under Phase 2. The objective is to include all potential market participants in order to maximize competition and minimize costs of delivering crude to the SPR. Phase 2 begins when Phase 1 ends, on August 1, 1999, and runs for a 6-month term with the potential for a second term. Planning for Phase 2 is currently underway.

All OCS leases will be available for inclusion in the program except for:

- Section 8(g) leases: These leases are excluded because the coastal States receive 27 percent of associated royalty receipts, and those States would lose an important revenue stream from SPR-dedicated leases. >
- Section 6 leases: These leases generally do not include language giving the government the option to take royalties in kind. They will be included in the program upon lessee agreement. >
- Leases dedicated to supply small refiners: These leases will be included when and if they are dropped from the small refiner program. >
- Leases in MMS' royalty reengineering program: Some 208 Gulf of Mexico leases are included in this important exploration and testing of new methods to manage mineral royalties. Some of these leases may be available under Phase 2 in the year 2000.

DOI/MMS Role. The MMS' role in the SPR initiative is to support the lead agency - DOE - in economic analyses and in the "upstream" logistics of royalty oil delivery at Gulf of Mexico leases. The MMS' role is to:

- Identify the Gulf of Mexico leases for which oil royalties can be received in kind and generate lease information for program implementation.
- Notify lease owners of any decision to take their royalties in kind, and inform them of their rights and responsibilities when paying royalties in kind.
- Continue to perform lease measurement and production accounting functions and supply DOE with data on production and royalty entitlement.
- Assist DOE in negotiations with lease owners for delivery of RIK oil to the SPR under Phase 1 of the program.
- In Phase 2 of the program, assist DOE in developing and issuing a competitive solicitation for delivery of oil to SPR facilities. We will also assist DOE in evaluating bids received and selecting the winning bidders.

Operational Considerations. Operational and logistical considerations that have been addressed to date include the following.

<u>Title transfer and contracting.</u> Using the provisions of the OCS Lands Act, DOI will transfer title to royalty oil to DOE at the OCS facility measurement point, typically on the lease. DOE will award and administer contracts for delivery of crude oil to the SPR facility or nearby market center. In both phases, crude oil will move to the SPR by standard industry practice. We anticipate that the most common scenario will be the award by DOE of exchange contracts in which royalty oil will be provided to the contractor in exchange for a market-based volume of SPR crude either at or near the SPR facility or at the market center. DOE will arrange for any final transportation needed to move crude from an exchange point not located at one of the SPR sites.

<u>Imbalances.</u> The operator/lessee will be required to maintain a balancing account to track monthly

imbalances that may occur in deliveries of royalty oil to DOI. The operator will work together with DOI and DOE to resolve monthly imbalances by increasing or decreasing deliveries in the subsequent month. However, MMS retains the right to settle imbalances via cash payment or accounting adjustment at the end of each contract term.

De Minimis Leases. A substantial number of offshore properties produce small amounts of crude oil, much of which is condensate associated with natural gas production. For example, nearly 30% of offshore properties produce less than 1 barrel per day. In Phase 1, we have negotiated for RIK deliveries primarily from high producing leases. In Phase 2, we have not yet decided whether to include all available leases or to exclude those leases producing de minimis amounts. The primary factors we are considering are the administrative costs for the government to analyze the economics and monitor compliance for each of these leases and the transaction costs for the industry to deliver RIK for the de minimis leases.

Next Steps. For the combined Phase 1 and 2 program, DOE/DOI plan to take up to 28 million barrels of royalty oil at the lease, which is estimated by OMB to have a fiscal impact of $170 mm in Fiscal Year 1999 and $200 mm in Fiscal Year 2000 (using OMB's FY 2000 budget ecomomic assumptions of price projections of $12.39 and $14.12, respectively) in decreased revenues to the Treasury. Actual fiscal impact will depend on actual delivery dates, quantity of oil transferred, and market oil price at the time.

It is premature to identify at this point how many barrels will be actually delivered into the SPR from the up to 28 million barrels of royalty oil identified for potential delivery to DOE at the lease. The actual amount of crude oil delivered to the SPR will depend on the specific details of negotiated agreements (Phase 1) and successful bids in the competitive auction (Phase 2). The primary determinant will be the location and quality differentials between the value of the royalty oil at the lease and the value of the oil delivered to the SPR sites. At least 15% of the 28 million barrels of RIK oil will be taken in the 3-month Phase 1 term.

We will be very busy this Spring as we work with DOE to develop and conduct the competitive bidding process under Phase 2 for royalty oil deliveries to the SPR. Specifically, we will assist DOE in developing and releasing a Request for Offers (RFO); preparing an evaluation plan; arraying economic and lease data to support the economic analysis of bids; and evaluating, negotiating, and selecting bids. We anticipate that contracts will be awarded on or before July 1, 1999 for Phase 2 deliveries that will commence August 1, 1999.

In closing, let me state that we look forward to continuing to work with DOE to complete the transfer of 28 million barrels of royalty oil. We believe that this program will enhance the energy security of our nation. We also believe that this program illustrates that as managers of public assets we can and must remain agile and flexible to respond to changing public needs. Using our RIK option to partially fill the SPR is a good example of how we can retain such flexibility.

Thank you Madam Chairman and Members of the Subcommittee, this concludes my prepared remarks. I would be pleased to answer any questions you may have.